

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 99-0152
Adjusted Gross Income Tax—Business/Non-Business Income
Tax Administration—Penalty
For Tax Years 1995-1997**

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ISSUES

I. Income Tax—Business Versus Nonbusiness Income

<u>Authority:</u>	IC § 6-3-1-20	45 IAC 3.1-1-29
	IC § 6-3-1-21	45 IAC 3.1-1-30
	IC § 6-3-2-1(b)	45 IAC 3.1-1-31
	IC § 6-8.1-5-1(b)	45 IAC 3.1-1-58
		45 IAC 3.1-1-59
		45 IAC 3.1-1-60

May Department Stores v Indiana Department of Revenue, 749 N.E.2d 651 (Ind.Tax, 2001)

Taxpayer protests the auditor's reclassification of certain types of income from non-business to business income.

II. Tax Administration—Penalty

<u>Authority:</u>	IC § 6-8.1-10-2.1	45 IAC 15-11-2
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Taxpayer protests the imposition of the 10% negligence penalty.

STATEMENT OF FACTS

Taxpayer manufactures medical, electronic, fabric, and industrial products, selling them throughout the world. Taxpayer has a number of subsidiaries, including overseas corporations in countries where taxpayer does business. In Indiana, taxpayer has inventory on consignment to various hospitals, with a single Indiana salesperson holding the remainder of taxpayer's in-state inventory.

The Department audited taxpayer for tax years 1995 through 1997, determining that certain types of income taxpayer had classified as “non-business” should have been classified, for Indiana Adjusted Gross Income Tax purposes, as “business income.” Therefore, additional tax was assessed and the 10% negligence penalty was imposed.

Taxpayer timely protested, arguing that the income at issue was “non-business.” A hearing was held wherein taxpayer presented some evidence of the non-business nature of the income at issue. The Department requested further information and taxpayer has provided it. Additional facts will be provided as necessary.

I. Income Tax—Business Versus Non-Business Income

DISCUSSION

Taxpayer protests the reclassification of income received from its investment portfolio from non-business to business income. Taxpayer also protests the reclassification of interest received from loans to foreign affiliates, dividends from ownership interests in other affiliates, and a small amount of capital gains, as business income. Taxpayer argues that the income is “non-business” because none of it serves any operational functions within its overall corporate structure. Taxpayer’s investment committee, whose purview is separate from the operations arm of the company, decides when and where to invest taxpayer’s surplus cash. At the hearing, taxpayer was asked to provide the Department with further information regarding the committee and its decision-making processes. The Department also requested that taxpayer provide documentation and narrative explanations of all contested income reclassifications.

Under IC § 6-8.1-5-1(b), a “notice of proposed assessment is *prima facie* evidence that the department’s claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.”

IC § 6-3-1-21 defines “nonbusiness income” as “all income other than business income.” *See also*, 45 IAC 3.1-1-31. Secondly, IC § 6-3-1-20 defines “business income” as “income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer’s regular trade or business operations.” *See also*, 45 IAC 3.1-1-29:

“Business Income” Defined. “Business Income” is defined in the Act as income from transactions and activity in the regular course of the taxpayer’s trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer’s regular trade or business.

Nonbusiness income means all income other than business income.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is “business income” or “nonbusiness income” is the identification of the transactions and activity which are the elements of a particular trade or business.

The Indiana Tax Court in *May Department Stores v. Indiana Department of Revenue*, 749 N.E.2d 651 (Ind. Tax 2001), 2001 Ind. Tax Lexis 32, clarified the statutory and regulatory language cited above, and outlined the transactional and functional tests the Department must apply to distinguish business from non-business income.

In *May*, the Indiana Tax Court construed the definitions of “business income” under IC § 6-3-1-20 and IC § 6-3-1-21 (non-business income). As the court noted, the “distinction between business and nonbusiness income is important in calculating a taxpayer’s tax liability . . . whether income is deemed business or nonbusiness income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states wherein the taxpayer is conducting its trade or business.” *May*, 749 N.E.2d 651 at 656. The court found that “ . . . in passing IND. CODE § 6-3-1-20, the General Assembly provided two tests for defining business income . . . the ‘transactional’ and ‘functional’ tests.” *Id.* at 662. The court goes on to say that IC § 6-3-1-20 “requires that not only the property’s disposition but also its acquisition and management must be integral parts of the taxpayer’s regular trade or business.” *Id.* at 664.

Under the transactional test, the nature of the particular transaction generating the income is the controlling factor the Department uses to identify business income pursuant to *May*. Three considerations enter into the Department’s identification process: the frequency and regularity of similar transactions; the former practices of the business; and taxpayer’s subsequent use of the income.

Under the functional test, gain from the disposition of a capital asset is considered business income if the asset disposed of was used by the taxpayer in its regular trade or business operations. According to the court in *May*, the regulation found at 45 IAC 3.1-1-30 requires the Department to consider the following in determining the scope of a taxpayer’s trade or business:

1. The nature of taxpayer’s trade or business.
2. The substantiality of the income derived from activities and transactions and the percentage of that income which forms taxpayer’s total income for a given tax period.
3. The length of time the property producing income was owned by taxpayer.

4. The taxpayer's purpose in acquiring and holding the property producing income.

Under the functional test, the Department must focus on the property being disposed of and the relationship between the property at issue and taxpayer's business operations. The question to be asked is whether the property, its use and /or disposition, forms an integral part of taxpayer's business.

The Investment Committee invests surplus funds with a "horizon" of 5-10 years, to maximize returns while managing investment risks. Allocation of assets with the Investment Fund changes as financial conditions warrant; allocation of assets is consistent with the risk and returns parameters outlined by taxpayer. Taxpayer then steps back from the operations of the Committee. The Committee monitors returns achieved by portfolio managers, recommends corrective action if returns do not meet the standards taxpayer has set forth, and makes periodic adjustments. Portfolio managers exercise complete investment discretion within the boundaries described. Investment objectives are intended to provide quantifiable benchmarks against which the progress toward long-term investment goals can be measured.

Given the fact that taxpayer is in the business of manufacturing tangible personal property for sale, income derived from long-term investment strategies is not business income. If taxpayer were to cease its Investment Committee's activities, there would be no effect whatsoever on taxpayer's day-to-day, month-to-month, or year-to-year manufacturing and marketing operations. There would also be no effect on taxpayer inventory or operations in Indiana.

The Committee's view is long-term, with one goal; thus, if investment parameters are met, no changes occur. Taxpayer invests surplus cash this way; taxpayer does not actively oversee or utilize the income to further its manufacturing operations and objectives, i.e., to increase its market share of medical products sold to hospitals and doctors. Therefore, under the transactional test, income from these investments is non-business because the transactions giving rise to the income have nothing to do with manufacturing, or the sale of products in Indiana.

So, too, under the functional test: taxpayer's use and disposition of surplus cash for investment purposes do not serve an integral part of taxpayer's business, manufacturing.

The tests as applied to dividends received from investing in foreign affiliates show that this income is also non-business. Taxpayer lacks any means of controlling operations in the foreign affiliates; they do not rely on taxpayer to conduct operations because they function autonomously and independently of taxpayer's manufacturing goals. The transactions are passive financial investments; if taxpayer withdrew its investment, nothing would happen to taxpayer other than receiving no income from dividends. Nothing would happen to taxpayer's inventory and operations in Indiana.

As applied to the interest on loans to foreign affiliates, the tests demonstrate that interest on the loan to the German subsidiary is business income. The promissory note signed by the parties shows that this is a long-term loan, almost 10 years old, to a subsidiary looking for cash to pursue its own long-term growth strategies. Taxpayer analyzed and entered into the loan

transaction back in the early 1990's for tax purposes related to federal and foreign tax rates. 45 IAC 3.1-1-59 states that "interest income is nonbusiness income if the intangible with respect to which the interest was received did not arise out of or was not created in the regular course of the taxpayer's trade or business operations." The original intangible was an accounts receivable owed to the taxpayer by the German subsidiary. Taxpayer converted the accounts receivable into a long-term loan. Thus, the German subsidiary pays interest on the loan, not the accounts receivable.

The Department's research into the issue of transforming an accounts receivable—an intangible arising out of and created "in the regular course of the taxpayer's trade or business operations"—into a loan reveals nothing on point either way, i.e., business or nonbusiness income. The Department therefore upholds the characterization of the interest as business income. Taxpayer has the burden of proof on all issues raised in a protest, and has presented insufficient evidence to show that the interest on the loan to the German subsidiary is not business income.

The analysis concerning the loan to the Italian subsidiary is similar. The promissory note for the loan between taxpayer and the Italian subsidiary indicates that the Italian subsidiary needed an additional influx of cash to relocate its offices; there were difficulties in selling the old offices, and "general business conditions" required taxpayer to give the Italian subsidiary more cash for its operational functions. Therefore, the acquisition, management, and disposition of the loan proceeds were directly for the Italian subsidiary's operational functions. The interest on that loan is therefore business income to the taxpayer.

FINDING

Taxpayer's protest concerning the Audit Division's reclassification of income from certain transactions from non-business to business income is partially sustained and partially denied. Interest gained from taxpayer's investment portfolio and dividends are nonbusiness income. Interest received from the loans to the German and Italian subsidiaries are business income.

II. Tax Administration—Penalty

Taxpayer protests the imposition of the 10% negligence penalty. Taxpayer argues that it had reasonable cause to characterize as non-business the income from the transactions described, *supra*. Taxpayer's characterizations were based solely on taxpayer's interpretation of the relevant statutes and regulations which the Indiana Tax Court has only recently construed.

Indiana Code Section 6-8.1-10-2.1(d) states that if a taxpayer subject to the negligence penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department **shall** waive the penalty. Indiana Administrative Code, Title 45, Rule 15, section 11-2 defines negligence as the failure to use reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by Indiana's tax statutes and administrative regulations.

In order for the Department to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of assessed taxes was due to reasonable cause. Taxpayer may establish reasonable cause by “demonstrat[ing] that it exercised ordinary business care and prudence in carrying or failing to carry out a duty giving rise to the penalty imposed. . . .”

FINDING

Waiver of the penalty is appropriate in this instance. At the time, Taxpayer exercised ordinary and reasonable business care in characterizing the income at issue as non-business rather than business income.

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